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—What is Book Value?

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The Revenue Act of 1945

BY W. H. DAVIDSON
(New York Office)

The Revenue Act of 1945, enacted November 8, 1945, was designed primarily to grant some tax reduction to corporations and individuals for 1946 and subsequent years and for fiscal years ending in 1946. There follows a brief digest of the more important provisions, chiefly those affecting corporations.

CORPORATION NORMAL AND SURTAX RATES

The corporation normal tax remains unchanged as follows:

If normal-tax net income exceeds $50,000.............. 24 per cent

If normal-tax net income does not exceed $50,000 the following rates apply to each portion of the income.

Normal-Tax Net Income	*Rate*
0-$ 5,000	15 per cent
$ 5,000-$20,000	17 do
$20,000-$25,000	19 do
$25,000-$50,000	31 do

For taxable years beginning after December 31, 1945 the surtax rate on corporations with surtax net income over $50,000 is 14 per cent in lieu of the rate of 16 per cent under prior law, making the combined normal and surtax rate on such corporations 38 per cent in lieu of the 40 per cent under prior law.

The surtax rate on corporations with surtax net income not over $25,000 is 6 per cent in lieu of 10 per cent under prior law. For corporations with surtax net incomes over $25,000 but not over $50,000 the surtax is $1,500, plus 22 per cent of the surtax net income over $25,000. The surtax rate on the Supplement Q surtax net income of regulated investment companies is a flat 14 per cent as compared with 16 per cent under prior law.

In the case of taxable years beginning in 1945 and ending in 1946 tentative taxes are computed under the law applicable to years beginning on January 1, 1945 and beginning on January 1, 1946 and the tax is the sum of a portion of each according to the number of days of the taxable year falling in 1945 and in 1946.

EXCESS PROFITS TAX

The excess profits tax will not apply to taxable years beginning after December 31, 1945. In the case of fiscal years beginning in 1945 and ending in 1946 the excess profits tax will be an amount equal

to that portion of a tentative tax computed under the law applicable to taxable years beginning on January 1, 1945 which the number of days in the taxable year prior to January 1, 1946 bears to the total number of days in the taxable year. The increase in the excess profits tax specific exemption from $10,000 to $25,000 provided in the Tax Adjustment Act of 1945 never became effective.

Though the excess profits tax will not apply to taxable years beginning after December 31, 1945 the unused excess profits credit carry-back will be retained for another year. There will be no unused excess profits credit carry-back from taxable years beginning after December 31, 1946. In the case of fiscal years beginning in 1946 and ending in 1947 there may be carried back such part of the unused excess profits credit as the number of days in such taxable year prior to January 1, 1947 is of the total number of days in such taxable year.

The Senate Finance Committee Report states that the unused excess profits credit for a taxable year beginning in 1946 may be computed by taking into account a constructive average base period net income determined under section 722. The Report also states that the Committee will consider the necessity or desirability of retroactive legislation to prevent abuses in connection with carry-backs, particularly from 1946. It states that these abuses might arise from devices or transactions entered into for the purpose of securing a carry-back or through transactions having the apparent effect of creating carry-backs in situations unrelated to the purpose of the carry-back provisions.

The Commissioner is authorized to prescribe regulations covering carry-backs from taxable years beginning after December 31, 1945 where consolidated income tax returns are filed for such year, or where separate returns are filed for such year but consolidated returns were filed in a prior year, and taxpayers are bound by such regulations as may be in effect prior to the due date of their tax returns for years beginning after December 31, 1945, including extensions of time.

The period of limitation for filing refund claims attributable to a net operating loss carry-back or to an unused excess profits credit carry-back is now the period ending with the expiration of the fifteenth day of the thirty-ninth month following the end of the taxable year of the net loss or the unused excess profits credit which results in such carry-back. However, if a Consent has been filed extending the period of limitation for assessing additional taxes for the year of the net loss or unused excess profits credit the refund claim may be filed at any time up to six months after the expiration of the Consent.

Income from Discharge of Indebtedness

Under existing law, in the case of a corporation, there may be excluded from gross income any income attributable to the discharge of indebtedness if the corporation consents to a reduction in the tax basis of its assets. The provision would not apply to taxable years beginning after December 31, 1945 but under the new law it will apply to taxable years beginning before January 1, 1947.

War Loss Recoveries

It was recognized that it would be unfair to subject war loss recoveries to declared value excess-profits tax because a corporation did not have the foresight to protect itself in its capital stock tax return against such a contingency. The new law contains a provision, the effect of which is to limit the declared value excess-profits tax on such recoveries to an amount equivalent to the amount of additional capital stock tax that would have been required to eliminate such declared value excess-profits tax.

Effective with respect to taxable years ending after June 30, 1945 and before July 1, 1946 where war loss recoveries are included in net income, the declared value excess-profits tax will be the amount of such tax computed by excluding war loss recoveries from net income, plus the lesser of the following amounts:

(1) 1¼ per cent of the amount of the war loss recoveries or

(2) 1¼ per cent of such portion of the net income which would be subject to declared value excess-profits tax under the law prior to the new amendment.

Capital Stock Tax and Declared Value Excess-Profits Tax

The capital stock tax is repealed for years ending after June 30, 1945. That is, the returns due July 31, 1945 were the last returns required and no capital stock tax will be payable for the year ending June 30, 1946.

There will be no declared value excess-profits tax for any taxable year ending after June 30, 1946. Taxable years ending on or before June 30, 1946 will still be subject to declared value excess-profits tax based upon the declared value in the capital stock tax return for the year ended June 30, 1945.

Individuals

For taxable years beginning after December 31, 1945 a tentative normal tax is computed at 3 per cent and the total normal tax is then reduced by 5 per cent, making the effective normal tax rate 2.85 per cent. The new law allows the same exemptions for normal tax as for surtax, that is generally $500 each for the taxpayer, his spouse and each of his dependents.

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The Significance of the Balance Sheet
What is Book Value?*

BY WALTER A. STAUB

The late Mr. Justice Oliver Wendell Holmes is quoted as having said, "We need emphasis on the obvious rather than elucidation of the obscure." As I seek to present the subject we have before us for discussion, you will probably feel I am following rather closely the injunction of the learned justice. Much of what I shall say regarding the balance sheet is more or less obvious on the face of it, or can be deduced from the descriptions of the various items which appear on it; however, emphasis needs to be laid upon what it purports to present, and on what it does not present, in order to make clear its significance. I shall endeavor so to review various phases of the subject as to lead to some conclusions as to what may be the significance of the balance sheet, and to an answer to the related question of what is book value.

The balance sheet is only one of two major financial statements of an enterprise, the other being the income statement. The balance sheet is seldom usable or dependable for conclusions without also making reference to, and study of, the income statement.

Years ago when the banks first began to develop their credit departments—perhaps thirty-five to forty years ago—it was the common thing for them to receive from their borrowers only a balance sheet. Originally, it was a balance sheet prepared by the borrower without any indication of examination or verification by anyone independent of the borrower. As time went on, a certified balance sheet began to be requested (or demanded) by the lending banks, but for many years they got only a balance sheet and not an income statement with it.

We go back to those days for the origin of the rule-of-thumb that for many years was followed by the credit departments of the banks regarding the balance sheet, namely, that it had to meet a minimum test of $2 of current assets for each $1 of current liabilities, the thought no doubt being that the enterprise

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*This article by Mr. Staub appeared in the August, 1945 issue of *The New York Certified Public Accountant* and was based on an address given by him on May 3, 1945, for the course on Current Problems in Accounting for Lawyers given by the Practising Law Institute in cooperation with the American Institute of Accountants and the New York State Society of Certified Public Accountants.

This was the last article written by Mr. Staub prior to his death last November and it is now reprinted here in the belief that it may be of interest to those readers of the JOURNAL who do not receive *The New York Certified Public Accountant*.

could then, in liquidation, experience a shrinkage of 50% in its current assets and still pay off the current liabilities. As the years went on, however, the banks began to recognize—as other creditors did, too—that the balance sheet in itself is not a sufficient basis for evaluating the financial position or strength of a concern, or its ability to pay off its obligations as they fall due.

Balance Sheet not a Statement of Values

The balance sheet has, from one standpoint at least, only a limited significance: it is definitely not all things to all men, and it should not be understood as presenting net worth in the literal or colloquial meaning of those words. The term "net worth" was used years ago on a good many balance sheets: in the case of a corporation, the sum of the capital stock and surplus (which equaled the stated net assets) was designated as "net worth." However, that term gives a misleading impression as to the true content of the balance sheet, and what it really is, if it leads to regarding it as presenting in any literal sense the net worth of an enterprise. Particularly is this true because the balance sheet—as we shall see when analyzing the various items that appear on it—doesn't really purport to show values in the sense of either the present value or the realizable value of most of the assets appearing on it. When you get beyond cash, you immediately meet items the amounts for which are not necessarily intended to be a representation of their value.

It is true that, in the case of the current assets, you come closer to the idea of value than is the case when you come to such assets as plant, and intangible assets such as goodwill, trade marks, etc., but, basically, the balance sheet does not purport to set forth net worth or the value of the different items on it.

In seeking to define, or to express in a brief compass, what the balance sheet is, I come to this conclusion: that the balance sheet is primarily a presentation of the present status of the stockholders' investment in the business—thinking now of a corporate balance sheet—as based usually on the following factors:

(a) The capital paid in, less that (if any) returned to the stockholders; plus (b) profits realized in excess of dividends paid therefrom; minus (c) losses sustained; and plus or minus (d) any adjustments resulting from quasi-reorganization or other abnormal circumstances.

This concept of the balance sheet makes it clear that it is not intended ordinarily to be a statement of values.

Nature of Balance Sheet

Some years ago a Special Committee of the American Institute of Accountants on Cooperation with Stock Exchanges conducted an ex-

tended correspondence with the Committee on Stock List of the New York Stock Exchange pursuant to the request of that Committee for study of, and suggestion for improvement in, the form of corporate reports to stockholders. In a letter which that Committee wrote to the Committee on Stock List in 1932, this among other things was said:

The nature of a balance sheet or an income account is quite generally misunderstood, even by writers on financial and accounting subjects. Professor William Z. Ripley has spoken of a balance sheet as an instantaneous photograph of the condition of a company on a given date. Such language is apt to prove doubly misleading to the average investor—first, because of the implication that the balance sheet is wholly photographic in nature, whereas it is largely historical; and, secondly, because of the suggestion that it is possible to achieve something approaching photographic accuracy in a balance sheet which, in fact, is necessarily the reflection of opinions subject to a (possibly wide) margin of error.

Writers of text-books on accounting speak of the purpose of the balance sheet as being to reflect the values of the assets and the liabilities on a particular date. They explain the fact that in many balance sheets certain assets are stated at figures which are obviously far above or far below true values by saying that the amounts at which such assets are stated represent "conventional" valuations. Such statements seem to involve a misconception of the nature of a balance sheet.

In an earlier age, when capital assets were inconsiderable and business units in general smaller and less complex than they are today, it was possible to value assets with comparative ease and accuracy and to measure the progress made from year to year by annual valuations. With the growing mechanization of industry, and with corporate organizations becoming constantly larger, more completely integrated and more complex, this has become increasingly impracticable. From an accounting standpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future. How such expenditures shall be dealt with in accounts is the central problem of accounting. How much of a given expenditure of the current or a past year shall be carried forward as an asset cannot possibly be determined by an exercise of judgment in the nature of a valuation. The task of appraisal would be too vast, and the variations in appraisal from year to year due to changes in price levels or changes in the mental attitude of the appraisers would in many cases be so great as to reduce all other elements in the computations of the results of operations to relative insignificance.

Value Dependent on Earning Power

Another paragraph that carries the thought somewhat further reads:

It is apparent that the real value of the assets of any large business is dependent mainly on the earning capacity of the enterprise. This fact is fairly generally recognized by intelligent investors as regards capital assets such as plant and machinery, but it is not equally generally recognized that it is true, though to a lesser extent, in respect of such assets as inventories and trade accounts receivable. Those, however, who have had experience in liquidations and reorganizations, realize that in many industries it becomes impossible to realize inventories or accounts receivable at more than a fraction of their going-concern value,

once the business has ceased to be a going concern.

That was borne in on me thirty years ago when we were asked, in one of the offices of my firm, to take charge of the accounting for the liquidation of a concern that had been in the auto parts business. I remember the surprise with which I saw the way customers either denied liability or claimed all kinds of allowances and alleged defects in the articles with which they had been charged prior to the announcement that the concern was going into liquidation. In many cases the accounts were not of a size to warrant resort to legal measures for collection, and that bears out what I have just read, namely, that even receivables (the asset in the balance sheet that should be just about next to cash in its liquidity or realizability) are no longer realizable in full in the event of discontinuance of the enterprise.

To continue with the quotation from the 1932 letter mentioned,

To attempt to arrive at the value of the assets of a business annually by an estimation of the earning capacity of the enterprise would be an impossible and unprofitable task. Any consideration of the accounts of a large business enterprise of today must start from the premise that an annual valuation of the assets is neither practical nor desirable.

Accounting Conventions or Principles

Some method, however, has to be found by which the proportion of a given expenditure to be charged against the operations in a year, and the proportion to be carried forward, may be determined; otherwise, it would be wholly impossible to present an annual income account. Out of this necessity has grown up a body of conventions, based partly on theoretical and partly on practical considerations, which form the basis for the determination of income and the preparation of balance sheets today. And while there is a fairly general agreement on certain broad principles to be followed in the formulation of conventional methods of accounting, there remains room for differences in the application of those principles which affect the results reached in a very important degree.

This may be made clearer by one or two illustrations. It is a generally accepted principle that plant value should be charged against gross profits over the useful life of the plant. But there is no agreement on the method of distribution. The straight-line method of providing for depreciation which is most commonly employed by industrial companies, the retirement - reserve method used by utilities [this was written back in 1932], the sinking-fund method, the combined maintenance-and-depreciation method, and others, are supported by respectable argument and by usage, and the charges against a particular year may vary a hundred per cent or more accordingly as one or the other permissible method is employed.

Again, the most commonly accepted method of stating inventories is at cost or market, whichever is lower; but within this rule widely different results may be derived, according to the detailed methods of its application.

Most investors realize today that balance sheets and income account are largely the reflection of individual judgments, and that their value is therefore to a large extent dependent on the competence and honesty of the persons exercising the necessary judgment. The importance of method, and particularly of consistency of method from year to year, is by no means equally understood.

Those of you who read accountants' certificates know that in the present day the accountant's certificate usually refers to the fact that the statements are based on—or prepared in conformity with—accepted accounting principles. The word "principles" there may be regarded as more or less synonymous with "conventions" because it isn't "principles" in the sense of a natural law or a scientific principle, such as a mathematical principle, that is meant but it is rather "principle" in the sense of a "general law or rule adopted as a guide to action; a settled ground or basis of conduct or practice" (quoting from a dictionary definition). The Committee on Terminology of our Institute has also said that: "Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting."

One of the conventions that has become most widely accepted and most widely used, namely, that regarded as underlying the general practice of inventory valuation—i.e., cost-or-market-whichever-is-lower—is a good illustration of an accounting convention or an accounting principle. Although that concept or principle or rule has been enunciated for a great many years, it has really been only during the past generation or so that it has become widely recognized and generally accepted in business practice.

I well remember the time in the early 1900's when the average businessman objected rather violently to writing his inventory down, because market values or market costs had fallen below what he had originally paid for stock on hand, but on the other hand giving no recognition to apparent appreciation in value when the price movement had been in the other direction. This is so because the concept of cost-or-market-whichever-is-lower has grown out of long business experience and out of an element of conservatism that has developed in business practice; in other words, it is a recognition of the fact that, on the one hand, it is not wise to "count your chickens before they're hatched" but, on the other hand, well to anticipate or provide for potential losses.

If, as I surmise, most of you men are lawyers in active practice, I imagine you have found in your experience that many concerns have gone into bankruptcy where there was over optimism as to the value of the assets of the concern, but there were very, very few cases in which a concern suffered by being conservative in the view currently taken of its resources and its financial position generally.

Definition of Balance Sheet

In considering further a definition of the balance sheet, I should like to refer to one of the reports by

the Terminology Committee of the American Institute of Accountants. It was written in 1941, that is nine years closer to the present time than what I have been reading from the 1932 communication to the Stock Exchange:

The terms "balance sheet," "assets," and "liabilities" are so closely related that the definitions of the three can best be considered together. Indeed, often a balance sheet is first defined as a statement of assets and liabilities (or of assets, liabilities and capital) and the definition of assets and liabilities then undertaken. This procedure, however, overlooks the fact in regard to a balance sheet emphasized in the report of the Committee on Terminology in 1931, that it is a summary of balances prepared from books of account kept by double-entry methods, while a statement of assets and liabilities may be prepared for an organization for which no such books are kept. The Committee deems it advisable to emphasize this distinction in any definition. Moreover, "balance sheet" is a distinctly technical accounting term while "assets" and "liabilities" are less so. The Committee feels that "balance sheet" should be defined in terms of its accounting origin and that the relation thereto of assets and liabilities should be considered subsequently.

Considered in this way a balance sheet may be defined as:

"A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept by double-entry methods, according to the rules or principles of accounting. The items reflected on the two sides of the balance sheet are commonly called assets and liabilities, respectively."

Accounting analysis frequently requires that two accounts be carried, with balances on opposite sides, in respect to the same thing (for example, a building account and a building-depreciation account). In the balance sheet the net amount of such balances is usually though not invariably shown.

A special case of this kind is presented by a corporation which has a deficit. Preferably such a deficit should be deducted from the credit side of the balance sheet but it is still common to show it on the debit side. This being so, a deficit necessarily appears as an exception in the definition of asset which follows.

Those things which are reflected in the debit balances that are or would be properly carried forward are termed "assets," and those reflected in credit balances, "liabilities." Hence the expression "statement of assets and liabilities" is frequently used as synonymous with "balance sheet," though as already pointed out not every statement of assets and liabilities is a balance sheet.

Hence, also, "assets," as used in balance sheet headings, may be regarded as the name given to anything which is reflected as a debit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods. Since such debit balances may represent either property rights acquired, or costs or expenses incurred, the word "assets" is not synonymous with or limited to property but includes also that part of any cost or expense incurred which is properly carried forward upon a closing of books at a given date. The basis of such carrying forward is that the balances represent either (a) property rights or values acquired or (b) expenditures that are either recoverable in or proper charges against the future. A definition of "asset" as used in balance sheets, which is consistent with the proposed definition of "balance sheet," would be:

"A thing represented by a debit balance (other than a deficit) that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting."

In order to make the definition informative, the following addition might be made:

"The presumptive grounds for carrying the balance forward are that it represents either a property right or value acquired, or an expenditure made which has created a property right, or which is properly applicable to the future. Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in balance sheet classification."

The last-named is not an asset in the popular sense, but if it may be carried forward as a proper charge against future income, then in an accounting sense—and particularly in a balance sheet classification—it is an asset.

Similarly, in relation to a balance sheet, "liability" is:

"A thing represented by a credit balance that is or would be properly carried forward upon a closing of books of account kept by double-entry methods, according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock, deferred credits to income, and surplus are balance sheet liabilities in that they represent balances to be accounted for by the company; though these are not liabilities in the ordinary sense of debts owed to legal creditors."

In recent times there has been a disposition in uniform accounting systems of regulatory commissions to adopt some such terms as "Assets and other debits" and "Liabilities and other credits" as the titles of the two sides of the balance sheet. When analyzed, these terms are scarcely more illuminating than the headings "Debits" and "Credits" unless a clear distinction is drawn between the items that are assets and those that are other debits, with a similar distinction on the liabilities side. This is not done—or, at least, not accurately done—in such classifications.

Going-concern Basis of Balance Sheet

An important consideration when thinking of the significance of the balance sheet is its going-concern basis. No attempt is made in ordinary practice, when applying the principles or conventions of accounting, to go beyond the going-concern concept for the balance sheet. In other words, no attempt is made to provide for liquidation losses which may well be incurred in substantial amount if the enterprise is wound up or discontinued. I have already referred to that in reading from the 1932 letter of the Committee to the Stock Exchange, but I want to emphasize it again.

Many years ago I wrote an article for *The Journal of Accountancy* under the title of "Deferred Charges to Operations." I sought to develop the idea that, when you analyze the assets on a balance sheet and consider the basis on which they are stated, you find that the governing concept is primarily to determine in respect of each asset account what amount may properly be carried forward to future periods in the operation of the business and to set up that amount as an asset in the balance sheet.

For example, in the case of inventories, that is the real purpose in choosing the basis on which the inventories are set forth in the balance sheet. I shall seek to develop that a little further as we go on, but I want at this time to refer to the fact that, in stating the inventory in the balance sheet, it isn't necessarily what could be realized if the business were to be discontinued—more often it wouldn't be that amount—but it is the amount that may properly be charged to the operations of succeeding periods in the carrying on of the business.

The same thing is true of a manufacturing plant. The treatment of plant is one that rests on the concept of showing the investment in the plant and then spreading it over the period during which it is expected to be useful to the enterprise. That is likewise true of various types of intangible assets—for instance, a patent. The patent may fluctuate considerably in value depending on circumstances, but usually the cost of it is spread over the life of the patent and the amount that appears in the balance sheet is that part of the cost which has not yet been charged off to the fiscal periods during which the enterprise has already owned it or during the life that has already expired.

Cost or Value

One of the questions that has been discussed many times with regard to balance sheets, and to which I have already alluded, is whether balance sheets shall reflect primarily cost or value (and I am using "value" here in the colloquial sense, that is, in the sense of current or realizable value rather than in the accounting sense to which I shall refer directly). If you analyze the balance sheet of the average concern that comes to your notice, and particularly a balance sheet that has been the subject of examination by accountants and on which they have expressed their opinion, you will find that pretty largely the balance sheet rests on cost, initially, and not on value in the sense of current or realizable value. This is because the balance sheet serves those purposes which we shall develop as we go along, and because an attempt to revalue property (more particularly the fixed assets) at annual or other frequent intervals would be simply a guess that would have little value or useful purpose; whereas the use of cost and the gradual absorption thereof in successive income statements of the owning concern has, through long experience, been established as the practical basis for the balance sheet. In other words, if the balance sheet is on a going-concern basis, then the various assets should appear in the balance sheet as such amounts as may be regarded as applicable to future periods of operation.

There may come a time, how-

ever, when cost has been left so far behind, or circumstances have so radically changed, that it has lost the significance it would ordinarily have for balance sheet and income statement purposes. That is the time when either a reorganization or a quasi-reorganization may be resorted to. That is particularly true of concerns like railroads and other public utilities, but it is also true of industrial enterprises where the situation may become such that it is no longer realistic to go along on the basis of original cost less depreciation in the case of the property assets. In such case there is, in a sense, a stocktaking and a determination of what appears to be a fair value as a new start for the enterprise.

This has been done in the case of quite a number of our railroads during the past decade, just as it was about fifty years ago when so many of the railroads went through receivership. Conditions had become such that realism called for a new start with a valuation, according to the best estimate and judgment that could be expressed, of the assets or property which the corporation still had, together with such modification of its capital structure, as seemed correspondingly necessary or justified. Thus, a new balance sheet results, such as a corporation might set up, for example, when at organization it is taking over a partnership or a sole proprietorship and evaluates the assets acquired and the liabilities assumed, and records the capital structure which is created for the purpose of carrying on in corporate form.

I should like to touch now on the term "value" as used in accounting, because it has a specialized sense that ought always to be kept in mind, and we shall also have that in our thought when we get to the question. What is book value? Certainly that doesn't mean value in the ordinary or colloquial sense of that term.

Again quoting from the Committee on Terminology of the American Institute of Accountants on "Value and its Derivatives,"

Mr. Justice Brandeis has said and Professor Bonbright, in *Valuation of Property*, has proved that "value" is a word of many meanings. In the first place, just as beauty lies in the eye of the beholder, so worth lies in the mind of the appraiser. There is often no unique standard of worth which is both realistic and objective. The fact that there are different criteria of worth is strikingly illustrated in the Supreme Court decisions which have applied different methods of determining value in connection with the regulation, taxation, and reorganization of railroads, respectively. But apart from the difficulty of measuring "value" when the word is used to connote "worth," it is evident that in the literature of business, economics, and accounting, "value" is used in varying significances, not all of which have any definite connotation of worth. The word should, therefore, seldom if ever be used by accountants without a qualifying adjective. The word is, in fact, commonly employed in accounting to describe the figure at which an asset or liability is carried, even though the amount may be

determined by a process which is not one of valuation in any ordinary sense.

Since accounting is predominantly based upon cost, the proper uses of the word "value" in accounting are largely restricted to the statement of items at cost, or at modifications of cost. In accounting, the term "market value" is used in senses differing somewhat from those attaching to the expression in law. As applied to securities it means a sum computed on the assumption that value is measurable by market quotations; as applied to inventories it is a constructive market value compiled from a variety of considerations, including market quotations, cost of replacement, and probable sales price. In the case of so-called "fixed assets" the value shown in accounts is the balance of their cost after deducting recorded depreciation. Thus the following definition would seem to be appropriate:

"Value" as used in accounts signifies the amount at which an item is stated, in accordance with the accounting rules or principles relating to that item. Generally book or balance-sheet values (using the word "value" in this sense) represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

In thus emphasizing the fact that accounting values are predominantly costs, the Committee would like to make clear its view that costs are in general much more real and much more significant to those who use accounts, than values in the general meaning of that word. The recognition by The Supreme Court in recent decisions of the crucial importance of expectations for the always uncertain future as a factor in the determination of value confirms the wisdom of the complete rejection in accounting of the "worth" basis for the statement of assets not intended to be sold within any foreseeable future, such as fixed assets.

Before leaving the subject of value, I wish to emphasize what has already been implied in some of what I have read or said, namely, that value, in the ordinary or economic sense of the word, is dependent upon earnings in the case of most business enterprises, whether they are public utilities, industrial enterprises or even mercantile enterprises. It is particularly true of plant assets and of intangible fixed assets.

This is well illustrated by the fact that it is very seldom that the quotation for a listed stock is the same as the value shown for a share of the stock on the books of the enterprise whose stock is listed on the stock exchange.*

An illustration that I have never forgotten of how dependent value is on earnings (of course it is true generally of business enterprises, but this one has particularly remained in my mind) is that of a railroad which has several times gone through reorganization. In the early 1900's the Chicago Mil-

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*A specialized exception to the general rule that corporations do not attempt to give effect to current values in their financial statements is that of investment companies (the so-called "investment trusts").

Either in the formulation of the balance sheets of such companies or by parenthetical information given therein, recognition is given to quoted values of their principal asset, viz., securities owned, and the resulting net asset value per share of outstanding capital stock is stated.

waukee & St. Paul Railroad ran from Chicago to St. Paul and perhaps as far as Omaha. It enjoyed a good investment standing—its bonds particularly enjoyed a high rating, as I recall it—and the road was highly regarded both as a well-situated property and as financially sound. Somebody got the inspiration that it ought to become a transcontinental road, so it was extended to the Pacific Coast. It went through a lot of new territory and I am under the impression that at one time prior to World War I it didn't fully meet even its operating expenses. The road was a fine accomplishment so far as engineering and every aspect of its physical and operating planning was concerned, but, not being able to earn its fixed charges, it landed in receivership.

I recall that one, if not more, eminent engineering firms made a study of the road for the receivers, and made a favorable report so far as concerned the physical property and its engineering aspects. It was probably the best constructed of all the transcontinental roads at that time, but that didn't overcome the fact that its actual value was measured by the practical test of what it could earn, and on that basis its value was far below the cost of constructing and equipping the road. So it went through reorganization and its securities were scaled down and a new start was made. It was a concrete demonstration that value finally is dependent upon what return can be earned on property rather than on its cost.

Varying Bases for Stating Balance Sheet Items

I should like now to get just a little closer to grips with the various classes of items in the balance sheet for the purpose of indicating that there are varying methods of stating the different classes of assets in the balance sheet. That may seem confusing at first. It is important to bear in mind, when thinking of what book value may be, that the only basis on which you can really justify it, or account for it, is the fact that, primarily, we have cost as the basis and then modifications from that point on for special circumstances or because of the special nature of the various classes of assets.

Assets

The average balance sheet of, say, an industrial concern includes the following major classifications of assets (taking them in order of realizability or of current status):

Cash

Marketable securities (if any)

Receivables (notes and accounts)

Inventories

Fixed assets of a tangible nature, such as land, mineral deposits, timber lands, buildings, machinery, and other plant items

Other securities (of affiliated companies or for other reasons not readily marketable)

Intangible assets, such as patents, trade marks and trade brands, goodwill, etc.

Deferred charges, either prepaid expenses, such as rent or insurance, or such deferred charges as bond discount and expense, etc.

Cash: The cash item speaks for itself. Ordinarily it is considered as representing that many dollars-and-cents of bank balances and cash on hand. We had one unfortunate period within the last decade-and-a-half when one did look with an inquiring eye upon the cash item in a balance sheet, because if it was considerable you wondered how the banks stood in relation to the demands which might be made upon them by their depositors. Fortunately, at the present time there doesn't seem to be any reason to raise that question in the case of the ordinary balance sheet.

Marketable Securities: When marketable securities (which may be regarded as in large measure the equivalent of cash) are held by an industrial concern, in theory they are carried in the balance sheet in the same manner as inventories, viz., at cost or market, whichever is lower, the market amount being based on stock exchange or over-the-counter quotations. However, since market quotations continually fluctuate, it is not unusual to carry marketable securities at cost (with a parenthetical note of their current quoted value), particularly if they do not constitute an item of outstanding amount in the balance sheet and any decline in quoted value is not unduly large.

Receivables: These are about the next thing to cash, and the only consideration is whether many of the debtors of the customers are in a financial position that makes it doubtful whether the full amounts owing by them will be collected.

There are at least two different ways of making provision against that contingency. One is the older method of going through the accounts and attempting to evaluate them individually from the standpoint of whether or not they are likely to be collected in full, dependence being had upon the knowledge of the credit man and the efforts that have been made to secure collection, etc. The other way is one that has been adopted in more recent times by many larger concerns and one now recognized in the Internal Revenue Code, that is, of setting up a provision for losses on accounts receivable (and notes, as well) based on crediting to a reserve for bad debts a percentage of sales (based on experience) and charging thereagainst any losses sustained by reason of accounts or notes proving to be uncollectible.

There are a few industries where losses on receivables are so small as to be negligible, but most con-

cerns have to reckon with the bad debt factor to some extent. In the light of experience the provision of a reserve for bad debts is regarded today as better practice than simply attempting to ear-mark the accounts that may be believed to be not collectible in full. After all, every account at some time or other was recent, and apparently good, and, for that reason, the reserve method seems preferable to the other.

In some industries the bad debt factor is much larger than in others, for instance, in instalment selling where the loss on receivables may average as much as 10 per cent and where ordinary collection methods represent a very substantial cost. There the provision has to be substantial, and the receivables are by no means the equivalent of cash. As a matter of fact, in the case of instalment houses, there is another factor, namely, the discount factor because of the long credit terms extended to customers, which should receive consideration if one wished to go the limit in making provision for every contingency. In practice, however, this factor seldom receives recognition in a balance sheet.

Inventories: When we come to inventories, we are getting still further away from the cash equivalent. I have already referred to the general basis of valuing inventories—using the word "valuing" in the accounting, rather than colloquial, sense—and stated that the valuation is based on determining, primarily, what is a fair charge to the succeeding fiscal or operating period for the inventory at the end of a fiscal period. The basic concept of valuing the inventory is something akin to saying, "If we were replacing this inventory today (the end of the period or the beginning of the following period), what would it cost us?," on the theory that it is fair to charge a succeeding period no more than the management would have to pay in purchasing the materials or producing the finished goods constituting the inventory in order to carry on the business in such succeeding period.

That raises a good many questions of detail and of varying applications of the general principle. For instance, what is cost? That sounds like a simple question to which the natural answer is what one pays for an article. But when you have accumulated a lot of materials bought at different times at a variety of prices, how are you going to charge those used against the operations of the period? In some businesses it is feasible to make a charge for the specific lots of materials that are used in manufacture or for the articles which are sold. For instance, a diamond concern can usually pick out the cost for a particular diamond that it is selling. It does run into a little complication when it cuts up diamonds, but even there the cost can

usually be allocated because ordinarily only very large diamonds are cut up and the costs can be kept on a basis of the resulting divisions of the originally larger diamonds. Another type of business where specific costs can be generally applied is contract work where orders are taken before there is actual manufacture, in other words, made-to-order goods. There the materials can usually be charged to the cost of the finished product on the basis of specific lots of materials, but in the great majority of industrial concerns, that is hardly the feasible thing to do.

In practice, the methods most used are: (a) average cost, (b) first-in, first-out, and (c) last-in, first-out. All three of these methods are based on assumptions which are rarely in precise accord with the physical movement of materials going into productive processes of merchandise which is taken from stock to fill sales orders. On an over-all basis, however, they afford a practical means of determining costs of production and sales and of valuing inventory for the balance sheet which produces reasonable results.

When considering the difference between "first-in, first-out" and "last-in, first-out," we encounter a development that grew out of World War I and became very much the subject of consideration and of actual application early during World War II. With the quickness of the American to develop slogans, "first-in, first-out" has become known as FIFO and "last-in, first-out" as LIFO.

World War I taught a bitter lesson to many concerns through the disappearance after the war of the profits which they thought had been made during the war. During that war prices rose, as you remember, to great heights. Business concerns were showing extraordinarily large profits because it was a seller's market. They had goods which had been bought at pre-war prices and they were selling them at the seller's market level. But, coincident with the selling of those goods acquired at low prices, came a necessary acquisition of goods to replace those sold.

Let's for the moment consider a mercantile concern. It had to make the replacement at higher prices. If it put the replacement purchases into the inventory at the higher price, it meant that the inventory level of prices for the same quantity of goods was constantly rising, coincident with a showing of handsome profits on the sales. In 1920, you remember, came a terrific drop in the price level, and a great many concerns in that year had to write off large inventory losses because of the market having dropped so far below the replacement prices at which they had been buying goods in the year or two preceding. That caused many people—and accountants, especially—to wonder whether

there wasn't a better procedure possible than showing abnormal profits, only to see a substantial portion of them vanish again when there was something approaching a return to normalcy and the seller's market no longer existed.

In the interim between World War I and World War II the quest for an answer to this query crystallized in the thought that there ought to be a closer relationship—or closer "relativity," to use Professor Einstein's term—between the selling price used on the one side of the income statement and the cost charged thereagainst on the other, and that such relativity would be more realistically set forth if you matched against the sales price the cost of the goods that had to be bought (or produced) to replace those that were being sold. Thus developed the concept of "last-in, first-out," instead of "first-in, first-out" which had been the more general practice theretofore followed.

During World War II a number of concerns have switched over to the last-in, first-out inventory method because it meant that they showed a lesser amount of taxable income by excluding therefrom profits which, judging from the experience of World War I and the post-war period immediately following, might prove illusory. Incidentally, that was an important consideration in reviewing the experience of World War I, namely, that of having paid high taxes on the apparent profits realized and seeing those profits vanish in a later period of losses, when losses could not be carried either back or forward.

So we have today a number of business concerns that state their inventories on the last-in, first-out basis, which is usually on a lower price level than where the first-in, first-out method has been followed for the determination of cost.

We next come to the question of what is "market." Many people think "market" means what you can get for a thing, but that isn't the accounting concept of market when applied to inventories. It is rather market in the sense of what you would have to pay in the market if you replaced the inventory that you had on hand at the close of the latest fiscal period, whether it be raw materials or whether it be finished goods. You might not be able to buy the finished goods in that state, but you could compute the cost of what would be entailed in replacing them by taking ruling rates of material costs and labor costs and normal overhead. This would apply also to that part of the inventory that represents goods-in-process.

I mention these details in regard to the inventories to indicate again that, in considering the balance sheet, you have a good many variations of value, so-called, with regard to the different assets.

Fixed Assets: Land (as distinguished from minerals in it or timber on it) is most often carried from period to period at what it cost, without any allowance for depreciation. Ordinarily we think of land, whether used for manufacturing or for agricultural purposes, as not being a depreciable item; certainly the Treasury thinks so. However, the point has been made by some of the cotton growers in the South that they are exhausting their land from one period to another, and they ought to be allowed a deduction for depletion of the land because of exhaustion of agricultural mineral content and resultant reduction of successive crops of cotton; just as a mining concern is exhausting the content of its land holdings when it is taking ore out of the ground. If he is a wise cotton grower he is putting fertilizer back on the land, and is allowed a deduction for his fertilizer, so you get into rather an argumentative subject there.

Mineral deposits are a different proposition because there, obviously, with every unit of mineral taken out of the ground, you are depleting and exhausting the asset that involved a certain cost.

Broadly, the same consideration applies to timber lands, although there you do have the possibility of reforestation, for which you have nothing comparable in the case of mineral deposits. However, reforestation is a long, long project as compared with cutting down standing timber.

Buildings are often not as much limited by physical life as they are by the factor of obsolescence. Buildings in downtown New York which are 50 years old have suffered very much from the obsolescence factor, though the physical chances are that they would stand another 50 or 100 years, or even longer, with adequate maintenance. The factor of useful life, as distinguished from mere physical life, needs to be emphasized.

Machinery and similar plant items, which involve a broad principle of depreciation, are treated on the same basis as buildings for balance sheet purposes. All those assets subject to depreciation and depletion through operation or lapse of time exemplify the concept that I read from the letter of the Institute Committee to the Stock Exchange in 1932, namely, that the basic problem in stating both balance sheet and income statement is that of determining a fair allocation among successive fiscal periods of the costs of the various kinds of property that are either the subject of manufacture or are used in the process of manufacture, whether you are talking about inventories or whether you are talking about so-called fixed assets.

Intangibles: When you get into intangible assets you have an interesting subject with specialized aspects. The Securities & Exchange

Commission has been giving it some attention, and, interestingly enough, seems inclined to go to the extreme of an ultra-conservative balance sheet in considering the accounting treatment of this class of assets. Members of the Commission's staff, in the case of trade brands and good will for instance, seem desirous of encouraging the writing off of such intangible assets, regardless of the fact they may in fact be becoming more and more valuable.

Take, for instance, a cigarette-making concern which has been in business many years and spends many millions of dollars a year for enhancing the potential earning power of the intangible assets represented by its trade brands, all of such expenditure being absorbed in the income statement from year to year. Nevertheless, judging from what members of the Commission's staff have been saying in the last year or two, they would like to see the income statement charged not only with the maintenance of the asset value but with an amount to amortize the asset itself. This seems to be going to an uncalled for extreme.

Deferred Charges: This class of asset may be made up of many different items. A prepaid expense has been incurred when rental has been paid for the first three months of the next year. Obviously, that is an expense applicable to the succeeding period which ought to be carried forward, at least as a nominal asset, in the balance sheet. Then you have such a deferred charge as bond discount, where a bond issue has been sold to the public which runs for, say, thirty years, and it is sold at 90 or 95. That discount really applies to the whole period of thirty years as a part of the cost of the use of borrowed capital during that time. The discount might be allocated on a mathematical basis, so that you have the effective rate of interest reflected in the combined charge to the income account for interest and discount. As a matter of convenience, however, it is usually allocated evenly over the period with appropriate adjustments for bonds reacquired.

Revaluation: Reference has already been made to variations in methods of allowing for depreciation of fixed assets. The question may be raised, with regard to that class of assets, whether revaluation is ever justified, either upward or downward. We have seen both, in the last two decades, in a great many industrials and utilities. During the 1920's a great many enterprises had appraisals made and, with a marked rise in the price level over what it had been prior to World War I, wrote up their property accounts accordingly. During the early 1930's, many industrial concerns wrote down their property accounts, presumably because of a fall in the price level and the consequent reduction in the charge for

depreciation that would need to be made to operations during the depression period, when operating results were otherwise already on a very lean basis.

There are special cases, undoubtedly, where revaluation even upward may be justified. Let's take a mineral property, undeveloped on being acquired, where a rich vein of ore has been discovered. Here is a case where, obviously, there may be justification for writing up the asset to its apparently demonstrated present value. This is the exception, however, that proves the general rule, because in the case of the ordinary industrial property I think experience indicates that it is rarely that revaluation upward is justified. When it is done, because of special circumstances, subsequent depreciation charges ought to be based on the written-up value, since there is practically a representation to creditors, or even to stockholders, that a capital asset of greater value than its original cost is being used in the business, and hence the operations ought to be charged with depreciation on that increased value.

By and large, the experience of accountants (and I think the experience of businessmen in the last two decades has emphasized it) has been that revaluations upward are usually unwise and most often unwarranted by the circumstances, especially when consideration is given to the long pull.

Liabilities

When we get to the other side of the balance sheet, there isn't the same need for differing bases of valuation or statement that we found among the various classes of assets that I have mentioned. You have your current liabilities and your long-term liabilities, which are expressed in the amounts eventually payable. Some of our college professors in accounting have argued for showing the long-term debt on the basis of the amount that was actually received for bonds outstanding, if sold at a discount, and gradually stepping up the liability as it comes closer and closer to maturity. That hasn't seemed realistic to most practicing accountants, and in practice that phase of the situation seems to be adequately taken care of if the discount is carried among the deferred charges on the debit side of the balance sheet and amortized over the fiscal periods to which it applies.

Contingent Liabilities

A difficult question in the case of some balance sheets is that of reflecting contingent liabilities. Contingencies are inherent in all of human life and experience, and contingent liabilities are one of the things to be constantly encountered and wrestled with by the business man and the accountant. They are found more in some cases than in others. Some concerns seems to be like some human beings: they seem

to be the beneficiaries of hard luck more than others. Some concerns have a way of running into infringement suits on patents with litigation that stretches out over the years, accompanied by the uncertainty of what the final outcome may be. Will they eventually have to make a large payment in an infringement suit, thus divesting themselves of the profits they thought they had made on the product they produced and which in the infringement suit it is claimed never was theirs to make? Renegotiation of profits during the war period is another of these contingencies that raises many questions.

There are many other types of contingencies which may, or may eventually, require substantial expenditure. In many cases the contingency is so indeterminable that it isn't feasible to set up a definite amount as a recognized liability to provide for the amount that may have to be paid when the contingency is finally resolved. This has been true in a great many tax cases because of the far-fetched claims that many revenue agents have made, sometimes running into fantastic amounts, with the Commissioner of Internal Revenue consequently alleging a deficiency which it may take some years to resolve. In many such cases, the best that can be done is to disclose, as best may be, the nature of the contingency, perhaps the amount which the contingency involves, and leave it to the reader's judgment as to what may be the ultimate effect. Because contingencies are frequently disclosed in footnotes—even if not in dollar amounts—it is important to read such notes for a full understanding of a balance sheet.

Reserves

The word "reserve" has been loosely and widely used in balance sheets, with the result that there are many categories of reserves. First, there is the valuation type of reserve, as for example that for depreciation to which I have already referred. Here the normal practice has become that of showing the reserve as an application to, or deduction from, the cost of the asset. The result is to show that portion of the investment in the fixed asset which is being carried forward as a charge against the future operations which will presumably get the benefit of the remaining use of the asset.

We have so-called reserves for liabilities, such as taxes. They are called reserves more because there hasn't yet been a final determination of what the precise payment may have to be when the liability is entirely cleared than because they are a true reserve.

Then we get into that very nebulous realm of reserves that may be anything from a provision for a contingency that is presently indeterminable to a general reserve for

contingencies that is in reality a segregation of surplus.

There is a class of so-called reserves that represents segregated or appropriated surplus. This is the case where, under the terms of an indenture, say, for a preferred stock sinking fund, a certain proportion of the earnings is required to be set aside for the purpose of providing for the purchase of preferred stock through the sinking fund and where the object, whether expressed or not, is in substance the gradual replacement through earnings retained in the business of the capital that was originally acquired through the issuance of such preferred stock.

Proprietorship Section of Balance Sheet

Capital Stock: In the case of a corporation, proprietorship starts with the capital stock, which may be of a number of classes with varying rights and preferences, the par or stated (declared) value of which may be different from the amount that was actually paid in for a given class of stock. Under present practice capital stock is shown in the balance sheet at par or stated value, any excess payment for the stock being credited to Capital Surplus (also termed Paid-in Surplus). When cumulative dividends are in arrears on any class of preferred stock, that fact is disclosed in a note on the balance sheet as such dividends do not constitute an actual liability until declared payable by the board of directors.

Capital Surplus is the next subdivision of the proprietorship section of a corporate balance sheet. This account has been the cause of many "headaches" in recent years and the SEC has struggled with it. Capital surplus is a term which our Institute Committee on Accounting Procedure has been studying with the thought that perhaps a better accounting treatment of it could be found. One suggestion which has received consideration (and I think we might have gotten to some definite result by this time if the war had not directed everybody's attention to other things) has been to drop entirely the use of the term "capital surplus" and use the term "capital," which would be the actual capital paid in, and the statutory capital (whether of par or declared value) would be stated simply as a memorandum on the balance sheet.

Earned Surplus: I don't know how many of you gentlemen, in your law practice, have had to deal with the question: What is earned surplus? A definition suggested by the American Institute Committee on Terminology is as follows:

> Earned surplus is the balance of net profits, income and gains of a corporation from the date of incorporation (or from the date when a deficit was absorbed by a charge against the capital surplus created by a reduction of the par or stated value of the capital stock or otherwise) after de-

ducting losses and after deducting distributions to stockholders and transfers to capital stock accounts when made out of such surplus.

In other words, it represents accumulated or undivided profits.

Conclusions Regarding Significance of Balance Sheet

I should like at this point to lead up to some conclusions and see whether you agree with me as to some of the purposes the balance sheet may serve, and thus develop what the significance of a balance sheet may be.

In the first place, I suggest that a purpose which the balance sheet serves is the general indication of solvency, on a going-concern basis. That has ordinarily to do with, or may be deduced primarily from, the current assets (the several classes and the respective amounts thereof being stated and having in mind that they are more nearly intended to represent some approach to current value than what is true of the fixed assets) and the current liabilities payable from such resources in determining whether or not the concern is in a comfortable financial position with respect to meeting its current or short-term obligations.

With respect to long-term debt, the balance sheet cannot usually give by itself, any very definite indication of the concern's ability to meet that debt. Here recourse must be had also to the income statement, or a series of annual income statements, to determine whether or not the earning performance of the company is such that the fixed charges are being currently met (preferably with a margin) and that, taking into account what may be foreseeable by the management, the earning power is such that, if the debt cannot be wholly met out of earnings by instalment payments, then refinancing is feasible because the earnings are such that investors would be interested in either purchasing bonds or some class of stock of the concern and thus permit of refinancing as the long-term debt falls due.

Then, secondly, the balance sheet is a presentation of the present status of the proprietors' investment—and I am thinking of the proprietors as the stockholders in the case of a corporation. I mentioned earlier that, taken in a condensed fashion, the capital paid in, minus any capital returned to the stockholders through liquidating dividends or reduction in capital, plus accumulated profits and minus any losses, represents or is equal to the net assets. The kind of assets that the corporation has and the liabilities it must meet represent the status of the stockholders' investment in the company as it has been affected by the operations carried on since the founding of the enterprise.

Thirdly, the balance sheet serves a useful purpose as a kind of liaison between successive income state-

ments. Today the emphasis in the case of financial statements has swung to the income statement as contrasted with the emphasis that was placed on the balance sheet in the days when its primary use was for the securing of credit. Today, on the stock exchange it is the earnings which are being periodically reported by corporations that have the greatest influence upon the movements of prices for particular stocks, and the balance sheet serves as a liaison, or tying-in-together, of the earnings statements; so that, for example, in the earning statement we may see a relative charge for depreciation in the case of the asset that appears on the balance sheet, and any adjustments that may be required from period to period, or that are occurring in the case of the various assets or even sometimes in the liabilities, will, to the extent required, find their reflection in the income statement.

A fourth use of the balance sheet—through the comparison of balance sheets from one period to another and noting the changes that occur in the various assets and liabilities—is the data it furnishes (or, at least, permits of securing) for tracing what has become of reported earnings. The changes in balance sheet items are sometimes more significant than the items themselves.

From what has been said in discussing the balance sheet and some of the purposes it serves, it is evident that its significance should not be overstressed. It is an important financial statement, but it reflects only one phase of a corporation's finances and operations, and the very fact that there are different bases for reflecting in it different classes of assets makes it necessary that the reader should constantly bear in mind the natural limitations on its significance.

What Is Book Value?

"Book value" may be considered in two senses: (1) the amount at which a particular asset may be carried on the books and consequently on the balance sheet of the owning concern, and (2) the amount of net assets applicable to each share of a given class of capital stock as computed from the face of the books (or more conveniently from the balance sheet) of the issuing company.

In both cases it must be understood that the word "value" is being used in a technical sense and not in the sense of actual or present worth. It is a term of convenience and the possibility of its conveying a wrong connotation, even with the caution of the accompanying word "book," has led some accountants to use the term "book amount" in place of "book value" when referring to the amount at which a particular asset is carried on the books of the owning corporation.

(*Continued on page 32*)

The L. R. B. & M. Journal

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The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm: to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

Another Tax Law

The first article in this issue of the Journal contains a discussion of the principal features of the Revenue Act of 1945, the second major piece of federal tax legislation enacted during 1945. Two tax laws likewise were enacted during 1944, and present indications are that we may expect still another revenue act in 1946. The picture is one of piecemeal legislation, representing amendments to the Internal Revenue Code, with accompanying complexities. Changes in the law are so rapid that even the experts must find it difficult to keep abreast of the "rules of the game." We find,

for example, that a provision of the Tax Adjustment Act of 1945, enacted last July 31, raised the excess profits tax specific exemption from $10,000 to $25,000, effective for 1946, but that such provision never became effective as it was repealed in less than six months by the Revenue Act of 1945.

As has been stressed many times before, the only real remedy to the tax muddle is to have a complete rewriting of the country's basic tax law, but unfortunately that seems to be a long way off.

The Broad Street Post

One of the more pleasant happenings incident to the war was the appearance of *The Broad Street Post.* Its witty and chatty comments about personalities and happenings at the New York office, combined with news about the men in the services, served in a very special way to maintain the "esprit de corps" of the organization. Many of our servicemen have indicated that issues of the *Post* were looked forward to almost as eagerly as letters from home.

We shall miss *The Broad Street Post,* and extend to Mr. Rappaport, its editor and star reporter, congratulations on a job well done.

An Unusual Engagement

Because of the closeness of the elections last Fall in Louisville and in Jefferson County, Kentucky, recounts were made of the votes for most offices. By agreement of both parties representative accountants were engaged to make the recounts, our firm being among those selected to perform this work.

The fact that accountants were called upon to make the recounts is one more illustration of the reliance which is placed on their independence and integrity.

Notes

It is with great sorrow that we record the deaths of Homer Curtis Hulse, of our Philadelphia staff, John A. Marik, of our New York staff, and Oliver J. North, of our Louisville staff.

Mr. Hulse succumbed to a heart attack on Sunday, December 16, 1945. He had been continuously associated with our organization since September, 1919, and had been in charge of many of the most important engagements in the Philadelphia office. His mild manner, subtle humor and considerate nature endeared him to all of his fellow workers and won him a host of friends. It is a tragedy that such a promising life should be brought to so sudden an end.

Mr. Marik also died suddenly of a heart attack on Saturday, December 29, 1945. He was 54 years of age, a lawyer and certified public accountant, and had been a member of the tax department of the New York staff since January, 1930, specializing in the fields of state and local taxation. Quiet and unassuming in nature, a diligent worker, he commanded the respect of his associates and those of our clients who had occasion to consult with him on tax matters.

Mr. North likewise died suddenly of a heart attack on December 6, 1945. He was only 45 years of age, and had been a member of the Louisville staff since September 1, 1942. Prior to his joining our organization he had been associated with Stokely-Van Camp, Incorporated, and the predecessor Van Camp Company. He was a member of the famous Rainbow Division during the first World War, and military honors were bestowed during the funeral services.

Mr. Hulse, Mr. Marik and Mr. North will be greatly missed, and our sympathy goes out to the members of their respective families in their bereavement.

Miss Storey Retires

On Thursday, November 29, 1945, a farewell party was given by the staff of the New York office to Miss Reba Storey. The affair, marking Miss Storey's retirement as general secretary of the New York office after twenty-eight years of service, was attended by most of the staff and by the partners. Miss Storey was the recipient of several presents from the staff and also received a testimonial signed by all of the partners and by many of the staff and office force.

Prior to the staff party, the partners met to wish Miss Storey much happiness in her well earned re-

tirement. Mr. Lybrand then presented her with a suitably engraved watch as a token of the affection and esteem in which she is held by her many friends in L. R. B. & M.

The October, 1945, issue of the *Journal of Accountancy* contained an article entitled "How a $41 Million War Contract Was Terminated," which was of particular interest to us because it was stated to be based on the successful application of the Consolidated Termination Program in the termination of a war contract between the Sperry Gyroscope Company, Inc., one of our clients, and the War Department, Corps of Engineers. The following paragraph made particular reference to the helpfulness of the reports of the company's independent C.P.A.'s in the proceedings:

> The reports of the company's independent certified public accountants were extremely valuable to both the government and the contractor in developing the basis for the termination proposal. Since the year 1944 had been audited and certified to by the company's accountants, the War Department accepted their findings without question, with respect to items of cost, deferred charges to operations, and capitalization of expenditures. Without such reports it would have been necessary for government personnel to have developed such accounting matters.

The "picture of the week" in the December 31 issue of *Life Magazine* is a photograph of the three learned Compton brothers, Karl, Arthur and Wilson, each of whom is a college president. It is interesting to note that two of the schools having Comptons as presidents, namely, Massachusetts Institute of Technology and Washington University, are clients of the firm.

Mr. Richardson addressed the concluding session of the American Management Association conference held in New York on December 7. In his talk Mr. Richardson dealt principally with the need for legislative action with respect to elimination of duplicate taxation on corporate earnings and the relief provisions from excess profits taxes provided for by Section 722 of the Internal Revenue Code.

On November 15, Mr. Richardson was guest speaker at a joint meeting of the Philadelphia chapters of the Pennsylvania Institute of Certified Public Accountants and the National Association of Cost Accountants, the subject of his talk being "Federal Income Taxes, Current Matters."

On December 13, Mr. Richardson spoke on "The Revenue Act of 1945" at a Federal tax meeting sponsored by the New York State Society of Certified Public Accountants.

On September 27, Mr. Fischer addressed the annual meeting of the Ohio State Society of Certified Public Accountants on the subject "Recent Developments in Auditing

Procedure and the Work of the Committee on Auditing Procedure of the American Institute of Accountants."

On November 13, at a luncheon meeting of the Philadelphia Chapter of the Chartered Life Underwriters, Mr. Fischer gave a talk on "How Can the Life Underwriter and the Accountant Best Serve the Client?"

On December 12, Mr. Halloran addressed the Bluegrass Retail Controllers Association on the subject "The Revenue Act of 1945."

Mr. Sweet is serving as Vice President of the American Institute of Accountants during the current fiscal year, having been elected to that office last October. Mr. Sweet had previously been a member of the Council of the Institute and had served as chairman and member of many Institute committees.

Mr. Sinclair is serving as First Vice President of The New York State Society of Certified Public Accountants, having been elected to that position earlier in 1945.

Mr. Russell has been elected a member of the Council of the American Institute of Accountants for a term of three years.

Mr. Harvey, now serving as president of the Massachusetts Society of Certified Public Accountants, was recently elected chairman of the Advisory Council of State Society Presidents, and in that capacity is a member of a special committee organized to supervise the carrying out of a formal plan of coordination of activities of the American Institute and the state societies.

Committees of the American Institute of Accountants appointed for the current fiscal year include in their personnel the following partners:

Mr. Sweet
Executive Committee

Mr. Schaffer
Committee on Accounting Procedure

Mr. Jennings
Committee on Auditing Procedure

Mr. Russell
Chairman, Committee on Professional Ethics

Mr. Harvey
Committee on Nominations

Mr. Drabenstadt
Committee on State Legislation

Mr. Richardson
Committee on Federal Taxation

Mr. Haas is serving as chairman of the Committee on Institute Publications of the Pennsylvania Society of Certified Public Accountants.

Our Philadelphia office is well represented on the committees of the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants. Mr. Fischer is serving on the Special Committee

on Cooperation with Veterans; Mr. Hewitt is Vice-Chairman of the Committee on Committee Appointments; and Mr. Harry C. Zug is a member of The Executive Committee and Chairman of the Committee on Study and Research.

"Well Done"

One of the proudest men in the Navy must be Lieutenant Commander Joseph B. Fyffe, U.S.N.R., a member of our Boston staff before joining the Navy.

Commander Fyffe was commanding officer of the destroyer-transport *Gosselin*, which was one of the first nine American warships to move into Tokyo Bay on August 28, 1945, to make effective the surrender of Japan. We can imagine the thrill he must have experienced!

The Fyffes are not new to Tokyo waters. Commander Fyffe is a son of the late Captain Joseph Fyffe, U.S.N., and grandson of the late Admiral Joseph Fyffe, U.S.N., both of whom spent many years in naval service in the Pacific area and the Orient. Tokyo was visited frequently by Admiral Fyffe, as was Nagasaki, port city stricken by the atomic bomb.

In an article which appeared in the March, 1945, issue of *Cost and Management*, official journal of The Canadian Society of Cost Accountants & Industrial Engineers, the author refers to an article written by Mr. Keast on "Cost Accounting Problems in the Canning Industry." Mr. Keast's article, which appeared in the L. R. B. & M. JOURNAL in 1938, is commended as "a well written article on certain problems in the industry, particularly raw produce."

Mr. Richardson and Mr. Harvey have been elected to membership in the New York State Society of Certified Public Accountants.

Mr. Howard W. Finney, of our Los Angeles staff, Mr. Duncan Bruce, of our Pittsburgh staff, and Mr. Henry C. Merriam, of our Boston staff, have been elected to membership in the American Institute of Accountants.

Mr. Joseph R. Harkness, of our Philadelphia staff, Mr. Jerry G. Kimbrough, of our Cincinnati staff, and Mr. Bernhard U. Krummel, of our San Francisco staff, have been elected to associate membership in the Institute.

The Revenue Act of 1945

(*Continued from page 3*)

The rate applicable to each surtax bracket is reduced by three percentage points in computing a tentative surtax, and then, as in the case of the normal tax, there is a flat 5 per cent reduction in the total surtax.

Giving effect to the 5 per cent reductions, the combined normal and surtax rate begins at 19 per cent and reaches 86.45 per cent on income in excess of $200,000. The total tax may not exceed 85.5 per cent of the net income as compared with 90 per cent under prior law.

In the case of fiscal years ending in 1946 the tax is computed partly at 1945 rates and partly at 1946 rates, as previously discussed in the case of corporations.

For taxable years beginning after December 31, 1940 all compensation received before the termination of the war as proclaimed by the President, for active service during the war in the United States military or naval forces by a member below the grade of commissioned officer is exempt from tax.

The new law extends the time for paying taxes attributable to service pay of commissioned officers, and also taxes attributable to preservice earned income for 1940 or 1941 which became due after the taxpayer's entry into the service.

The Significance of the Balance Sheet

(*Continued from page 25*)

If you want to determine the book value of a stock, assuming there is only one class outstanding, you divide the aggregate of capital stock and surplus (both capital and earned surplus) by the number of outstanding shares. If, however, you have several classes of stock, you must first deduct from the aggregate capital stock and surplus the preferences of any preferred stocks, and then divide the amount remaining for the common by the number of common shares outstanding.

Having in mind what has already been said as to the nature of the balance sheet, and the varying bases of stating the different classes of assets in the balance, it is obvious that the "book value" of a share of stock has decided limitations. The actual value of a share of stock is dependent on the earning power underlying it.

It is therefore obvious that book value is, after all, not a conclusive value for any stock. I referred earlier to the fact that very seldom is the quoted price for a stock the same as the book value. Book value has only a very general usefulness, and one that can never be conclusive or significant in itself. It has to be considered in connection with earnings, prospects of the business and any other factors that influence earning power.

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Cleveland 15	Midland Building
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